BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)
	)
PRESTON T. AND	)
VIRGINIA R. KELSEY	)

Appearances:

For Appellants:	Charles G. Stephenson Attorney at Law
	Donald F. Robertson Certified Public Accountant
For Respondent:	David M. Hinman Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Preston T. and Virginia R. Kelsey against proposed assessments of additional personal income tax in the amounts of $1,813.50 and $1,450.72 for the years 1970 and 1971, respectively.

The issue presented is the taxability of annuity payments received by a California resident as a beneficiary of a retirement pension, where the pension was earned by her nonresident father for services performed in Pennsylvania.

Appellant Virginia R. Kelsey, a California resident, is the current beneficiary of her father's retirement annuity. Her father, John Rice, participated in a group annuity plan as an employee of General Crushed Stone Corporation, a Pennsylvania corporation. No financial contributions were made by employees under the plan. It was a "qualified" pension plan within the meaning of the statutory provisions (Rev. & Tax. Code, § 17501 et seq.) providing for deduction of contributions by the employer and for taxation of pension payments when received.

Appellant's father, a lifelong Pennsylvania resident, performed his services as an employee outside this state. In accordance with the provisions of the group annuity plan, upon retirement he had a vested right to monthly payments of $1,511.32 for 20 years. After retirement on April 1, 1968, he received one payment before his death. Inasmuch as the monthly payments were not contingent upon his survival, his wife, Rebecca A. Rice, as his designated initial beneficiary, thereafter received them until her death. Upon Mrs. Rice's demise, appellant became the designated beneficiary and she has received the monthly sums since that time. In accordance with the decedent's beneficiary designations, if appellant should die within the 20-year period, the value of the annuity would be paid to her estate in a lump sum. She has been a California resident at least since the date of her father's retirement.

Appellant considered the annuity payments to be exempt from California personal income tax. Respondent concluded that they were taxable and issued proposed assessments. Its denial of the subsequent protest resulted in this appeal.

In the instant matter, appellant relies upon the fact that all the rights under the deferred compensation contract between her nonresident father and his employer accrued to Mr. Rice outside this state. As a result, appellant points out that all pension payments to him would not have been included in his gross income under California law whether received by him

outside this state (Rev. & Tax. Code, §17951), or even if received by him in this state if he had established residence in California (Rev. & Tax. Code, § 17596). (See also the Appeal of Dr. F. W. L. Tydeman, Cal. St. Bd. of Equal., Jan. 5, 1950.) She then contends that the annuity payments to her should likewise not be included in her gross income in view of the statutory provisions concerning "income in respect of a decedent."

Sections 17831 through 17838 are concerned with the taxation of "income in respect of a decedent." Section 17831 of the Revenue and Taxation Code sets forth the general rule:

> The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period ... shall be included in the gross income, for the taxable year when received, of:
>
> (a) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;
>
> (b) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or
>
> (c) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after distribution by the decedent's estate of such right. (Emphasis added.)

Section 17833 further provides:

> The right, described in Section 17831, to receive an amount shall be treated, in the hands of the estate of the decedent., or any person who

> acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income under Section 17831... shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount. (Emphasis added.)

Appellant maintains that the payments clearly are "income in respect of a decedent" in view of the construction of that language given by the courts. She then claim's that pursuant to section 17833, the income, as "income in respect of a decedent", should be treated just as if her father had received it and therefore should not be included in her gross income.

For the reasons explained below, we. agree with appellant that the payments to her are "income in respect of a decedent" within the meaning of section 17831 but we are unable to conclude that the income is thereby exempt from tax.

Sections 17831 and 17833, and their companion sections, arc based on and are substantially identical to the provisions of section 691 of the Internal Revenue Code. Enactment of section 691 was the result of congressional efforts to see to it that income which would have been taxable had the decedent lived to receive it should not escape income tax simply by reason of the decedent's death. (Commissioner v. 1 .inde, 213 F. 2d 1, cert. denied, 348 U. S. 871 [99 L. Ed. 686].) Prior to 1934, income accrued but not yet received-by a cash basis decedent as of the date of his death escaped income tax altogether because the decedent's accounting method did not require such amounts to be reported on his return and the courts had held that they also were not income to the decedent's estate. An obvious inequity resulted because an accrual basis taxpayer, unlike a cash basis taxpayer, was liable for tax on such earnings. Moreover, sizeable amounts of income escaped taxation.

To remedy this situation, Congress enacted section 42 of the Revenue Act of 1934, which provided that amounts accrued up to the date of the taxpayer's death should be included in computing the decedent's net income for the taxable year of his death, even though such amounts had not been received and regardless of whether the taxpayer had reported his income on the cash basis or otherwise. However, this often resulted in "bunching" into the decedent's final return a substantial amount of income which except for his death would have been spread over a number of years and subjected to lower rates of tax. In addition, when the courts were called on to construe this provision, the word "accrued" was given a broader meaning than it had in the context of the accrual method of reporting income, in order to effectuate the congressional purpose to bring "into income the assets of decedents, earned during their life and unreported as income." (Helvering v. Estate of Enright, 312 U. S. 636, 644 [85 L. Ed. 1093].) The result of the Enright decision, however, was to "bunch" into the decedent's final return even more items of income that would have been reported over several years, if the decedent had lived to receive them. Section 126 of the Internal Revenue Code of 1939, the forerunner of the present section 691, was enacted in 1942 to relieve this unfair bunching effect.

Therefore, the purpose of such legislation (and the purpose of the comparable California provisions) is to continue to tax the assets of decedents earned during their lifetime and unreported as income but to tax such earnings to the recipients rather than to the decedents in order to relieve the bunching. (See also the comprehensive explanation of the entire historical background in Davison's Estate-v. United States, 292 F. 2d 937, cert. denied, 368 U. S. 939 [7 L. Ed. 2d 337]; see also Commissioner v. Linde, supra; Bernard v. United States, 215 F. Supp. 256; Appeal of Estate of Marilyn Monroe, Deceased, Cal. St. Bd. of Equal., April 22, 1975.)

Consequently, deferred compensation derived from employment and accrued prior to death is clearly "income in respect of a decedent" and taxable to the recipient beneficiary. (Miller v. United States, 389 F. 2d 656; Estate of Nilssen v. United States, 322 F. Supp. 260; Collins v. United States, 318 F. Supp. 382, aff'd, 448 F. 2d 787; Bernard v. United States, supra.)

In fact, taxable "income in respect of a decedent" has even been held to include receipts of a beneficiary attributable to a decedent's activities as an employee even though the decedent had no enforceable right to any payment at the time of his death. (O'Daniel's Estate v. Commissioner, 173 F. 2d 966; Bausch's Estate v. Commissioner, 186 F. 2d 313.) Thus, in view of the purpose of this legislation, the recipient of the annuity payments derived from performance of employment services is taxed, under the "income in respect of a decedent" provisions, to the same extent as the decedent would have been had he received the proceeds.

Summarizing, we conclude that the purpose of such legislation is to place the recipient "in the shoes of the decedent" so that the taxing jurisdiction is not deprived of revenue which otherwise it would have had. (See Commissioner v. Linde, supra.) Under the facts before us, however, the decedent would not have been taxable if he had survived and received the annuity payments. Therefore, we agree with appellant that the "income in respect of a decedent" legislation does not- require her to include the monthly payments in gross income.

Jbwever, we are not only concerned with the effect of sections 17831 and 17833. We simply cannot ignore other statutory and regulatory provisions in determining whether the sums paid to appellant should be included in her gross income. In reviewing these applicable statutory and regulatory provisions, we find, subject to certain exceptions not relevant here, that gross income specifically includes amounts received as an annuity. (Rev. & Tax. Code, § 171.01.) Where an annuity contract is purchased by an employer for an employee pursuant to a qualified non-contributory plan, amounts received as annuity payments by a beneficiary after the death of an employee or retired employee are included in the gross income of that beneficiary. (Rev. & Tax. Code, §§ 17503, 17511; Cal. Admin. Code, tit. 18, reg. 17511(a), subd. (3), and reg. 17503, subd. (a)(Z).)[1/] Therefore, in accordance with these provisions,

1/ The distributions are also included in gross income for federal income tax purposes under the current federal law and regulations (Int. Rev. Code of 1954, §§ 72, 402, and 403; Treas. Reg., §§ 1.402(a)-1, subd. (a)(S), 1. 403(a)-1, subd. (c); see also Int. Rev. Code of 1939, §§ 22,165.)

the amounts received by appellant, as the current beneficiary, should be included in her gross income. (See also Ella B. Higgs, 16 T. C. 16.) Inasmuch as she is a resident of this state, her tax liability is not altered by the circumstance that the income was derived from sources outside this state. (See Rev. & Tax. Code, § 37041.)

In tracing the historical background of the "income in respect of decedent" legislation, there is absolutely no indication of any intention to exempt from taxation income which is taxation in accordance with statutory authority entirely separate from that legislation. To the contrary, as we have shown, one of the principal purposes of the legislation was to retrieve lost revenue. (See also Davison's Estate v. United States, supra.) It was not the purpose of this legislation to exempt from taxation income that would otherwise be taxable.

Therefore, we must sustain respondent's action.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Preston 'I'. and Virginia R. Kelsey

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Preston T. and Virginia R. Kelsey against proposed assessments of additional personal income tax in the amounts of $1,813.50 and $1,450.72 for the years 1970 and 1971, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 8th day of March, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____. Member

ATTEST: _____, Executive Secretary